

NOTE 26 – CONTINGENCIES AND COMMITMENTS

A. Primary Government

Litigation

In the government-wide and proprietary fund financial statements, the State accrues liabilities related to significant legal proceedings if a loss is probable and reasonably estimable. In the governmental fund financial statements, liabilities are accrued when cases are settled and the amount is due and payable.

The State is a party to various legal proceedings seeking damages, injunctive, or other relief. In addition to routine litigation, certain of these proceedings could, if unfavorably resolved from the point of view of the State, substantially affect State programs or finances. These lawsuits involve programs generally in the areas of corrections; tax collection; commerce and budgetary reductions to school districts and governmental units; and court funding. Relief sought generally includes damages in tort cases; improvement of prison medical and mental health care and refund claims under State taxes. The State is also a party to various legal proceedings that, if resolved in the State's favor, would result in contingency gains to the State, but without material effect upon fund balance/net assets. The ultimate dispositions and consequences of all of these proceedings are not presently determinable, but such ultimate dispositions and consequences of any single proceeding or all legal proceedings collectively should not themselves, except as listed below, in the opinion of the Attorney General of the State and the Office of the State Budget, have a material adverse effect on the State's financial position. Those lawsuits pending which may have a significant impact or substantial effect on State programs or finances, if resolved in a manner unfavorable to the State, include the following:

10th Judicial Circuit et al v State of Michigan et al: On August 22, 1994, the Ingham Circuit and Probate Courts, together with the 55th District Court, filed suits in the Court of Claims and Ingham County Circuit Court against the State of Michigan and Ingham County entitled, 30th Judicial Circuit et al v Governor et al for declaratory and injunctive relief, and for damages, due to the alleged failure of the State Court Administrative Office to properly calculate Ingham County's reimbursement under MCL 600.9947; MSA 27A.9947, the court funding statute. The 30th Judicial Circuit et al v Governor et al case has been dismissed by stipulation of the parties because the plaintiffs are raising the same claims as members of a class action captioned as 10th Judicial Circuit et al v State of Michigan et al (Saginaw Circuit Court No. 94-2936-AA-1/Court of Claims No. 94-15534-CM). Plaintiffs assert that the amount in controversy exceeds \$5 million. The case is currently pending final class certification.

Durant et al v State of Michigan: On November 15, 2000, more than 365 Michigan school districts and individuals filed two suits in the Michigan Court of Appeals. The first suit, Durant et al v State et al, ("Durant III") asserts that the current State School Aid appropriation act, P.A. 297 of 2000, violates Michigan Constitution, Article 9, §§ 25-34 (the "Headlee Amendment"), because it allegedly transfers per pupil revenue guaranteed to school districts under the Constitution of 1963, Article 9, § 11, for unrestricted school operating purposes, in order to satisfy the State's independent funding obligation to those school districts under Article 9, § 29. The plaintiffs in Durant III are seeking a monetary remedy, including approximately \$1.7 billion for the 1999-2000 through 2002-2003 school years for the State's alleged underfunding of special education programs and services, inclusive of special education transportation services. The Durant III plaintiffs are also requesting a declaratory judgment that the State, through P.A. 297 of 2000, is violating Article 9, § 11, and Article 9, § 29. The Durant III

plaintiffs further seek orders declaring that the State has failed, through P.A. 297 of 2000, to meet its constitutional duty to fund services and activities provided by the plaintiff school districts during school years 1999-2000 through 2002-2003 in the same proportion by which they were funded when the Headlee Amendment became effective, and that the State has reduced the State-financed proportion of necessary costs incurred by the plaintiff school districts for special education services for the 1999-2000 through 2002-2003 school years below that provided by the State when the Headlee Amendment became effective. The Durant III plaintiffs also seek an injunction permanently enjoining the State from making any future reductions below the levels of funding provided when the Headlee Amendment became effective to pay for the cost of the activities and services required of them by State law. They also seek attorneys' fees and costs of litigation.

The second suit, Adair et al v State et al ("Adair"), asserts that the State has, by operation of law, increased the level of various specified activities and services beyond that which was required by State law as of December 23, 1978 and, subsequent to December 23, 1978, added various specified new activities or services by State law, including mandatory increases in student instruction time, without providing funding for these new activities and services, all in violation of the Headlee Amendment. In the original complaint, the Adair plaintiffs sought an unspecified money judgment equal to the reduction in the State financed proportion of necessary costs incurred by the plaintiff school districts for each school year from 1997-1998 through the date of any judgment and for attorneys' fees and litigation costs. The Adair plaintiffs also sought a declaratory judgment that the State has failed to meet its funding responsibility under the Headlee Amendment to provide the plaintiff school districts with revenues sufficient to pay for the necessary increased costs for activities and services first required by State law after December 23, 1978, and to pay for increases in the level of required activities and services beyond that which was required by State law as of December 23, 1978.

On January 2, 2001, plaintiffs filed a first amended complaint in both Durant III and Adair increasing the number of school district plaintiffs to 443. On February 22, 2001, plaintiffs filed a second amended complaint in Durant III increasing the number of school district plaintiffs to 457. On April 16, 2001, plaintiffs filed a second amended complaint in Adair increasing the number of school district plaintiffs to 463. The second amended complaint includes a request for declaratory relief, attorneys' fees and litigation costs but does not include a request for money judgment.

Jefferson Smurfit Corporation v State of Michigan: On November 24, 1999, the Michigan Court of Claims in Jefferson Smurfit Corporation v State of Michigan, File No. 98-17140-CM, ruled that the site-based capital acquisition deduction in Michigan's single business tax act is unconstitutional. According to the Michigan Department of Treasury, the potential financial impact of this decision is approximately \$261 million. The State has appealed the decision. On November 13, 2001, the Michigan Court of Appeals issued its opinion reversing the decision of the lower court and holding that the capital acquisition deduction did not violate constitutional provisions. It is anticipated that the taxpayers will seek reconsideration or will file their application for leave to appeal with the Michigan Supreme Court.

Federal Grants

The State receives significant financial assistance from the federal government in the form of grants and entitlements. The receipt of federal grants is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable federal regulations. Substantially all federal grants are subject to either federal single audits or financial and compliance audits by grantor agencies. Questioned costs as a result of these audits may become disallowances after the appropriate review of federal agencies. Material disallowances are recognized as fund liabilities in the government-wide and proprietary fund financial statements when the loss becomes probable and reasonably estimable. As of September 30, 2001, the State estimates that additional disallowances of recognized revenue will not be material to the general purpose financial statements.

The Department of Community Health (DCH) administers the School Based Outreach Services Program to provide certain health services to school-aged children. A dispute arose between DCH and the U.S. Department of Health and Human Services (HHS) regarding costs which had been submitted to HHS for reimbursement. The dispute involved costs covering several years. In January 2002 the State and HHS negotiated an agreement to resolve the dispute. Although the U.S. Department of Justice must approve the settlement, the State views that action as a formality and has adjusted the accounting records at September 30, 2001, to reflect the impact of the settlement. In the event that the agreement is set aside, the State would again assert its claim for reimbursement for costs disallowed by HHS.

Federal sanctions that may result in a loss to the State include \$47.5 million for the Food Stamp Program and \$55.2 million for the Child Support Enforcement System.

Gain Contingencies

Certain contingent receivables related to the Family Independence Agency are not recorded as assets in these statements. Amounts recoverable from Family Independence Agency grant recipients for grant overpayments or from responsible third parties are recorded as receivables only if the amount is reasonably measurable, expected to be received within 12 months, and not contingent upon future grants or the completion of major collection efforts by the State. If recoveries are accrued and the program involves federal participation, a liability for the federal share of the recovery is also accrued. The unrecorded amount of potential recoveries, which are ultimately collectible, cannot be reasonably determined.

In November 1998, the Attorney General joined 45 other states and five territories in a settlement with the nation's largest tobacco manufacturers. The settlement includes base payments to states totaling \$220.6 billion over the next 25 years, and continues in perpetuity. Michigan's share of the settlement is expected to be \$8.5 billion over the next 25 years starting in 1998 and \$348.3 million thereafter, adjusted for inflation and other factors. The State also received \$2.2 million, representing costs incurred to litigate the case. While Michigan's share of the base payments will not change over time, the amount of the annual payment is subject to a number of modifications including adjustments for inflation and usage volumes. Some of the adjustments may result in increases in the payments (inflation, for example), while other adjustments will likely cause decreases in the payments (volume adjustments, for example). The net effect of these adjustments on future payments is unclear, therefore the financial statements only reflect amounts which can be reasonably estimated.

Construction Projects

As of September 30, 2001, several construction projects were in progress, with several others in the planning stages. A more detailed discussion of construction commitments is included in the construction in progress disclosures (Note 10).

The Department of Transportation has entered into construction contracts that will be paid with transportation related funds. As of September 30, 2001, the balances remaining in these contracts equaled \$583.2 million.

Contingent Liability for Local School District Bonds

Public Act 108 of 1961, as amended, resulted in a contingent liability for the bonds of any school district which are "qualified" by the Superintendent of Public Instruction. Every qualified school district is required to borrow and the State is required to lend to it any amount necessary for the school district to avoid a default on its qualified bonds. In the event that funds are not available in the School Bond Loan Fund in adequate amounts to make such a loan, the State is required to make such loans from the General Fund. As of December 31, 2001, the principal amount of qualified bonds outstanding was \$11.1 billion. Total debt service requirements on these bonds including interest will approximate \$972.0 million in 2002. The amount of loans by the State (related to local school district bonds qualified under this program), outstanding to local school districts as of September 30, 2001, is \$410.0 million. Interest due on these loans as of September 30, 2001, is \$78.8 million.

B. Discretely Presented Component Units

Student Loan Guarantees

The Michigan Higher Education Assistance Authority (MHEAA) is contingently liable for loans made to students by financial institutions that qualify for guaranty. The State, other than MHEAA, is not liable for these loans. MHEAA's default ratio is currently below 5% for the fiscal year ended September 30, 2001. As a result, the federal government's reinsurance rate for defaults for the fiscal year ended September 30, 2001, is 100% for loans made prior to October 1, 1993, and 98% for loans made on or after October 1, 1993 to September 30, 1998. In the event of future adverse default experience, MHEAA could be liable for up to 25% of defaulted loans. Management does not expect that all guaranteed loans could default in one year. At the beginning of each fiscal year, MHEAA's reinsurance rate returns to 98%. In the event of future adverse default experience, MHEAA could be liable for up to 25% of such defaulted loans. Accordingly, MHEAA's expected maximum contingent liability is less than 25% of outstanding guaranteed loans; however, the maximum contingent liability at September 30, 2001, is \$639.8 million.

MHEAA entered into commitment agreements with all lenders that provide, among other things, that MHEAA will maintain cash and marketable securities. MHEAA was in compliance with this requirement as of September 30, 2001, at an amount sufficient to guarantee loans in accordance with the Higher Education Act of 1965, as amended.

Multi-Family Mortgage Loans

As of June 30, 2001, the Michigan State Housing Development Authority (MSHDA) has commitments to issue multi-family mortgage loans in the amount of \$77.5 million and single-family mortgage loans in the amount of \$21.0 million.

MSHDA has committed up to approximately \$1.1 million per year for up to 30 years from the date of completion of the respective developments (subject to three years advance notice of termination) from its accumulated reserves and future income to subsidize operations or rents for certain tenants occupying units in certain developments funded under MSHDA's multi-family program.